Internal Revenue Service
memorandum

date: DEC 30

to: District Counsel, Seattle
ATTN: Terri Merriam

from: Special Counsel (International)

subject: [redacted]

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THIS DOCUMENT INCLUDES STATEMENTS SUBJECT TO THE ATTORNEY-CLIENT PRIVILEGE AND THE ATTORNEY WORK PRODUCT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYER(S) INVOLVED, AND ITS USE WITHIN THE IRS SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT FOR USE IN THEIR OWN CASES.

In response to our previous discussions, this memorandum in intended to provide our views concerning alternative approaches to sustaining adjustments involving certain offshore reinsurance companies.

We understand that the Western region and the Seattle district have a number of similar cases. This memorandum is intended to assist you in your providing advice to the examination division.

FACTS

You have under current examination [redacted]s Form 1040 for calendar years [redacted]-[redacted]. [redacted] ("taxpayer") owned [redacted] auto dealerships during the years at issue, and [redacted]% of [redacted], a foreign corporation. Taxpayer's son owns the remaining [redacted]% of [redacted]. [redacted] is incorporated in the [redacted] and [redacted] Islands and filed a Form 1120F as a reinsurance company for the years at issue. The statute of limitations has expired on [redacted] with respect to its income tax liabilities.

Taxpayer's dealerships sell life, accident and health insurance policies underwritten by [redacted] to customers. [redacted] is a domestic corporation unrelated to the dealerships. The dealerships sell extended warranty contracts underwritten by [redacted] and [redacted] also, U.S. corporations unrelated to Taxpayer or his dealerships. Because the I.R.C. provisions dealing with life insurance differ from those dealing with property casualty insurance, this memorandum will first discuss the life business (including accident and health) and then discuss the warranty business.

I. LIFE, ACCIDENT AND HEALTH POLICIES

A. Background

Taxpayer's dealerships sold life, accident and health insurance policies to their customers financing a car purchase.

The sales were made pursuant to agency agreements with [redacted]. The dealerships charged market price for the policies, retained [redacted]% of the premiums received as commissions, and forwarded the balance to [redacted] in California. [redacted] reinsured [redacted]% of the liability to [redacted], a [redacted] and [redacted] reinsurance company which is unrelated to [redacted], to taxpayer's dealerships or to taxpayer. We have not reviewed the reinsurance contracts themselves, but we understand that the reinsurance agreement provided [redacted] retain an administration fee and forward the balance of the premiums received to [redacted]. In reality, [redacted] administers the policies, processing and paying claims out of current premiums and forwarding the "underwriting gain" to [redacted]. We have no information regarding the payment of excise tax with respect to premiums ceded by [redacted] to [redacted].

[redacted] entered into a reinsurance contract with [redacted] for [redacted]% of the liability reinsured from [redacted]. This reinsurance agreement provided that [redacted] take an administrative fee and forward the balance of the premiums received to [redacted]. What [redacted] did in practice was to keep the funds it received from [redacted], less its own administrative fee, in a custodial account in the name of [redacted] and [redacted].[1] There is no written agreement as to how the custodial funds are to be handled, but Taxpayer had access to the joint "custody account" and made substantial

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[1]In order to cover [redacted]'s potential liability in the event that [redacted] failed to cover claims with current premiums, [redacted] held a certain amount of "reserves." This amount consisted of $[redacted] letter of credit backed by [redacted], and a certificate of deposit for $[redacted] in [redacted]'s name.

withdrawals during the years at issue.[2]

[redacted] has no office and no employees. It uses as its address the address of one of Taxpayer's car dealerships in Washington. [redacted] does not pay claims directly; as stated above, [redacted] pays all claims out of current premiums. [redacted] does not have a foreign bank account. [redacted] reported gross income effectively connected with a U.S. trade or business on its federal income tax return. The statute is open on [redacted] for income tax liabilities for [redacted] and subsequent years.

B. I.R.C. Section 842.

For all open years, we would recommend using I.R.C. §842 as the primary position to tax [redacted].

As stated above, [redacted] filed a U.S. federal income tax return for taxable years [redacted]-[redacted], reporting effectively connected income within the meaning of I.R.C. §864(c).

I.R.C. §482 provides that if a foreign insurance company carrying on an insurance business within the United States would qualify under part I or II of subchapter L for the taxable year (without regard to income not effectively connected with the conduct of any trade or business within the United States) if it were a domestic corporation, the company will be taxable under the applicable part on its income effectively connected with its conduct of any trade or business within the United States. Any U.S. source income not effectively connected to the conduct of a U.S. trade or business shall be taxable on a gross basis as provided in I.R.C. §881.

I.R.C. §864(b) provides that the term "trade or business within the United States includes the performance of personal services within the United States at any time within the taxable year. To constitute a trade or business within the United States there must be continuity of activity. Furthermore, case law suggests that regular and continuous activity or transactions must occur during some substantial portion of the taxable year."[3]

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[2]Taxpayer also made substantial withdrawals from [redacted]'s domestic bank account in Nevada.

[3]Spermacet Whaling & Shipping Co., 30 T.C. 618, 634 (1958), aff'd 281 F.2d 646 (6th Cir. 1960).

The fact that the agent who is conducting activities within the United States on behalf of a foreign principal is an independent agent will not affect the determination of whether the foreign principal is engaged in a U.S. trade or business.[4]

Regarding the issue of whether selling activities qualify a taxpayer as engaged in a trade or business, case law looks to the relationship between the foreign taxpayer and his contact in the United States. In Frank Handfield, 23 T.C. 633 (1955) the Court found that the relationship between the foreign taxpayer and his contact in the United States was one of principal/agent in the form of a contract of consignment. Based upon this finding, the Court held that the foreign taxpayer was engaged in a trade or business in the United States through a permanent establishment under the U.S.-Canada Income Tax Convention.[5]

In W.C. Johnston, 24 T.C. 92 (1955) petitioner was the member of a Canadian partnership ("CP"). The Court found that an agreement between CP and a U.S. partnership ("GSC") constituted a partnership ("P"). Because P was considered engaged in a U.S. trade or business, its nonresident alien partner (petitioner), by virtue of its membership in P is deemed to be doing business in the United States.

In order for [redacted] to assert that it was engaged in a U.S. trade or business, it would appear [redacted] would have to allege that the auto dealerships, [redacted] and [redacted] were its agents or subagents. The agreements between the auto dealerships and [redacted], the agreement between [redacted] and [redacted] and [redacted] are interconnected and interdependent and support the theory that [redacted] is engaged in a U.S. trade or business.

Having determined that [redacted] is engaged in a U.S. trade or business, I.R.C. §842, permits taxation of [redacted]'s effectively connected income. For taxable years ending on or before December 31, 1987, I.R.C. §861(a)(7) provided that amounts received as underwriting income (as

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[4]It can, however, severely affect the amount of income that is considered effectively connected to that business, and under provisions of tax treaties, it will affect the determination of whether the foreign principal has a permanent establishment. Neither of those concerns is relevant to our facts.

[5]Income Tax Convention, March 1942, U.S.-Canada, paragraph 3(f) Protocol T.S. 983; 56 Stat. 1399.

defined in I.R.C. §832(b)(3)) derived from the insurance of U.S. risks (as defined in I.R.C. §953(a)) are U.S. source income.

For taxable years beginning after December 31, 1986, I.R.C. §861(a)(7) provides that U.S. source income includes amounts received as underwriting income (as defined in I.R.C. §832(b)(3)) derived from the issuing or reinsuring of any insurance or annuity contract -

(A) in connection with property in, liability arising out of an activity in, or in connection with the lives or health of residents of the United States, or

(B) in connection with risks not described in (A) (above) as a result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect to issuing (or reinsuring) any insurance or annuity contract in connection with property in, liability arising out of activity in, or in connection with the lives of health of residents of, the United States.

I.R.C. §832(b)(3) provides the term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

I.R.C. §832(b)(4) defines the term "premiums earned on insurance contracts during the taxable year" under a formulary method. (I.R.C. §832(b)(4) was amended for taxable years beginning after December 31, 1986, and again for taxable years beginning on or after September 30, 1990).

I.R.C. §832(b)(5) defines the terms "losses incurred," under a formulary method. I.R.C. §832(b)(5) has undergone several changes. (See, P.L. 101-508, §11305(a), P.L. 100-647, §1010(d)(2), (d)(3), P.L. 99-514, §1022(a), §1023(a)(1).)

Taxation of [redacted]'s effectively connected income requires net taxable income. One item a foreign property and casualty insurance company is allowed to deduct in arriving at taxable income is losses incurred but not reported (a form of reserve). Life insurance companies are able to deduct life insurance reserves.

You have indicated your belief that these amounts have been grossly overstated by [redacted]. In order to determine whether [redacted] has taxable income under I.R.C. §842(a) an audit of [redacted]'s reserves is necessary. To the extent a reduction of reserves produces net taxable income such income (which is U.S. source) is effectively connected income under the provisions of I.R.C. §§864(c)(2) or 864(c)(3). (It is unclear whether reinsurance premiums qualify as fixed or determinable annual or periodical income ("FDAP") within the meaning of I.R.C. §§864(c)(2) and 881(a). If they are not FDAP, they are effectively connected under I.R.C. §864(c)(3).

A reduction in reserves would also increase [redacted]'s earnings and profits which might allow immediate taxation of Taxpayer as a result of his receiving a deemed dividend distribution. See discussion of I.R.C. §§551-556, and 951-964, below.

C. Foreign Personal Holding Company ("FPHC") Provisions I.R.C. §551-556

We alert you to these provisions (and to the Subpart F rules discussed below) in the event you decide to challenge [redacted]'s standing as a bona fide insurance company. If [redacted] is not considered an insurance company, it would be necessary to determine the character of the amounts previously booked as premiums. One possiblity is to characterize them as deposits. This would result in no income to [redacted]. If such amounts are deposits to [redacted], they may not be deductible by [redacted]. In the event such amounts are not recharacterized as deposits, it is unclear whether they could be the type of passive income covered by the FPHC rules.

Congress enacted the foreign personal holding company rules in 1937 to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks." If five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corproation that has primarily foreign personal holding company income (generally passive income such as dividends, interest, royalties, rents (if rental income does not amount to 50 percent of gross income) and income from certain personal service contracts that corporation will be a foreign personal holding company. In that case, the foreign corporation's U.S. shareholders, including U.S. citizens, residents, and corporations, are subject to U.S. tax on their pro rata share of the corporation's undistributed foreign personal holding company income. That is, though only individuals count in the determination of foreign personal holding company status, persons other than individuals may be subject to foreign personal holding company tax.

D. Subpart F - I.R.C. §951-964

[redacted] is a controlled foreign corporation ("CFC") within the meaning of I.R.C. §957 Taxpayer and his son are U.S. shareholders within the meaning of I.R.C. §951(b). Subpart F, much like the FPHC rules (above) is designed to tax U.S. shareholders on certain types of income earned by a CFC even though the income has not been distributed (limited to the CFC's earnings and profits).

Should you determine that [redacted] is not an insurance company the subpart F rules include as a category of tainted income, FPHC income as defined in I.R.C. §553 and as modified in I.R.C. §954(c). If the recharacterization of the premiums is considered FPHC income, the U.S. shareholders will be currently taxable (on an annual basis) to the extent [redacted] has earnings and profits in the Subpart F "basket."

Prior to 1985, the FPHC rules and the subpart F rules overlapped. For years prior to 1985, the Courts were split as to which section had priority. See, I.R.C. §951(d) (prior to 1985) and compare Whitlock v. Commissioner, 494 F.2d 1297 (10th Cir. 1974), cert. den., 419 U.S. 839 with Lovett v. United States, 621 F.2d 1130 (Ct. Cl. 1980). For taxable years after 1984, a statutory change to I.R.C. §954(d) gave priority to the Subpart F rules over the FPHC rules.

Although having no application to your facts, we apprise you of the following:

I.R.C. §952(a) includes as a category of income, insurance income as defined in I.R.C. §953. I.R.C. §952(b) excludes from Subpart F income U.S. source, effectively connected income. Thus, the Subpart F rules would not apply to [redacted] unless we did not challenge the classification of [redacted] as an insurance company and we determined [redacted] income was not U.S. source effectively connected income.

E. I.R.C. §956

I.R.C §956 is intended to prevent the use of earnings accumulated in a CFC, directly or indirectly by its U.S. shareholders. To accomplish this, I.R.C. §956 provides to the extent a CFC increases its investment in U.S. property from one year to the next, the amount of the increase is taxable to the U.S. shareholders (on a pro rata basis) to the extent of the CFC's earnings and profits.

Items of U.S. property are defined in I.R.C. §956(b). One such item is an obligation of a U.S. person. The Taxpayer is a U.S. person.

To the extent taxpayer has borrowed funds from [redacted] and not repaid them or included those amounts in gross income, he has investments in U.S. property. To the extent the amount invested increases from one year to the next, Taxpayer must include such amounts in income under I.R.C. §951. Note that the rules of I.R.C. §§956 and 951 apply notwithstanding that [redacted] (a CFC) has no subpart F income (as a result of the operation of I.R.C. §952(b).

I.R.C. §§956 and 951 provide statutory authority for including the unpaid or unreported advances in Taxpayers gross income on the Form 1040. Of course, the constructive dividend argument remains a viable alternative.

F. Section 482

Section 482 of the Code authorizes the Secretary to distribute, apportion or allocate gross income, deductions, credits or allowances among two or more organizations, trades or businesses owned or controlled by the same interests.

As regards our assumption of facts, the dealerships and [redacted] are commonly controlled entities within the meaning of I.R.C. §482. With respect to the dealerships sales of credit life, accident and health insurance, there is no inference that the income earned by the dealerships and by [redacted] is not at arm's-length (the standard to be applied under I.R.C. §482). However, should you advance a position that [redacted] is not a valid insurance company, I.R.C. §482 might be a vehicle to reallocate income from [redacted] to the dealerships *if* we could establish that [redacted] and [redacted] are mere conduits or agents of [redacted]. *See*, also the discussion of I.R.C. §845, below.

G. Reallocation under I.R.C. 845

(1) I.R.C. §845(a)

Congress enacted I.R.C. §845 of the Code in the Tax Reform Act of 1984, section 212(a) of P.L. 98-369. I.R.C. §845(a) is effective for risks reinsured on or after 9/27/83. I.R.C. §845(a) gives the Secretary broad authority in the case of two or more persons who are related within the meaning of I.R.C. §482, and who are parties to a reinsurance agreement (or where one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to such agreement or a conduit between related persons). The Secretary may (1) allocate among such persons income, deductions, assets, reserves, credits and other items related to a reinsurance agreement, (2) recharacterize any such items, or (3) make any other adjustment, if he decides that such allocation, recharacterization, or adjustment is necessary to reflect the proper source and character of the taxable income of each such person.

The dealerships and [redacted] are related parties within the meaning of I.R.C. §482, but they are not parties to a reinsurance agreement. Even were we to argue that both [redacted] and [redacted] are agents or conduits of the dealership of [redacted], there is technically no insurance or reinsurance agreement between the dealerships and anyone (at least with respect to the credit life business) because the policyholders in the life business are the car purchasers.

Thus, I.R.C. §845(a) cannot be used to reallocate income from [redacted] to either the Taxpayer or his dealerships because, while related to [redacted], neither is a party to the reinsurance agreements. At best, section 845(a) can reallocate income, expenses, etc. among the respective insurance companies involved in the transactions.

2 Section 845(b)

Section 845(b) of the Code is effective for risks reinsured after 12/31/84. Section 845(b) authorizes the Secretary to make proper adjustments with respect to any party to a reinsurance contract if the Secretary determines that such reinsurance contract has a significant tax avoidance effect on any party to such contract, to eliminate such tax avoidance effect.

The determination of whether a reinsurance agreement between unrelated parties has a significant tax avoidance effect with respect to one or both of the parties is a highly factual one and the Field should examine the economic substance of the transaction, considering factors such as (1) the duration or age of the business reinsured, because it bears directly on the issue of whether significant economic risk is transferred between the parties; (2) the character of the business reinsured in determining whether the tax benefits to any party are disproportionate to the risk transferred; (3) the structure for determining the potential profits of each of the parties and any experience rating; (4) the duration of the reinsurance agreement between the parties; (5) the parties' rights to terminate the reinsurance agreement and the consequences of a termination; (6) the relative tax positions of the parties; and (7) the general financial situations of the parties.

As applied to our facts the parties to the reinsurance contracts are [redacted] [redacted] and [redacted]. It seems that the administrative fees retained by [redacted] and [redacted] should be examined to determine whether they are excessive.

H. Excise Tax Provisions

I.R.C. §4371(2) imposes an excise tax of 1 percent of the premium paid on the policy of life, sickness or accident insurance issued by a foreign insurer.

I.R.C. §4371(3) imposes an excise tax of 1 percent of the premium paid on the policy of reinsurance covering any of the contracts listed above.

I.R.C. §4372(e) defines the term "policy of life, sickness or accident insurance" for purposes of I.R.C. §4371(2) to mean any policy or other instrument by whatever name called whereby a contract of insurance is made continued or reviewed with respect to the life or hazards to the person of a citizen or resident of the United States.

I.R.C. §4372(f) defines the term "policy of reinsurance" as any policy or other instrument by whatever name called whereby a contract of reinsurance is made continued or renewed against or with respect to any of the hazards, risks, losses or liabilities covered by contracts taxable under I.R.C. §4371 (1) or (2).

For premiums paid from February 1, 1977, until December 10, 1988, I.R.C. §4373(1) provided that the tax imposed under section 4731 did not apply to any policy signed or countersigned by an officer or agent of the insurer in a State, or in the District of Columbia, within which the insurer is authorized to do business.

The decision in The Neptune Mutual Association, Ltd v. United States, 88-2 USTC para. 16469 (Fed. Cir. 1988) involved the following facts:

Neptune was a foreign corporation engaged in a trade or business within the united States within the meaning of I.R.C. §864(b). The issue was whether Neptune was liable for federal excise tax with respect to U.S. source premium income or whether it was subject to federal income tax under I.R.C. §842.

The issue arose because I.R.C. §§842 and 4371 overlapped; i.e., Neptune was subject to both the income tax and the excise tax under a literal reading of I.R.C. §§842 and 4371.

The government conceded that Neptune should not be liable for both taxes.

The Court concluded that the overlap of I.R.C. §§842 and 4371 was unintended and was a result of legislative inadvertence.

The Court stated that in cases involving the overlap "presumably, as here, the IRS will assess the tax that produces the more revenue."

Neptune was subject to the excise tax under I.R.C. §4371 because it did not qualify for the exemption under I.R.C. §4373. Although Neptune was engaged in a U.S. trade or business within the meaning of I.R.C. §864(b) and Neptune may have had authorization to do business from the state Commissioner of Insurance, Neptune did not have the authority to sign or countersign policies as required by I.R.C. §4373.

This technical overlap was corrected with an amendment to I.R.C. §4373 effective for premiums paid after December 10, 1988. Such premiums are exempt from the excise tax if effectively connected with the conduct of a U.S. trade or business.

Thus for premiums ceded and paid by [redacted] to [redacted] up through December 10, 1988, you may want to consider whether excise tax should be assessed.

I. Can/Should We Sham [redacted]?

You have indicated that one argument you may advance is to treat [redacted] as a sham.

Since Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), courts have been reticent to sham corporations. In Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1987), the court cited the alternative requirements of business purpose of business activity established in Moline Properties for determining whether a corporation will be recognized as a taxable entity. The Court concluded that LTD, the foreign subsidiary of Hospital Corporation of America, had both a business purpose and some minimal business activity and therefore was not a sham.

While we cannot determine the relative strengths and weaknesses of a particular case without more factual information, the standard for what constitutes business purpose and business activity seem sufficiently low after Hospital

Corp. of America, that it is possible that a court could find [redacted] has a business purpose of conducts a business activity.

In Hospital Corp. of America, the parent corporation was in the business of managing hospitals and usually organized a domestic subsidiary for each of its domestic hospital management contracts. The Tax Court found this to be a pattern of doing business that justified the organization of a foreign subsidiary to manage its foreign contract. The Service argued that such form was not necessary for the conduct of business but the Court declined to "second guess" the parent's business acumen.

Taxpayer has no similar pattern of doing business to constitute a business purpose under Hospital Corp. of America, but in view of the discussion above regarding trade or business, this business purpose activity may be virtually presumptive.

The Tax Court also found that the foreign subsidiary in Hospital Corp. of America conducted at least minimal business activities. It may be easy to demonstrate that [redacted] does not even meet those minimum activities since it does not have an office, telephone, employees, a foreign bank account (although we understand it does have domestic bank account), never paid any claims itself, and appears to be simply a signature on a joint account with [redacted].

We understand that the Taxpayer's conduct is particularly egregious when the life business and the warranty transactions (discussed below) are viewed together, and that you believe those facts weigh in favor of the sham argument. It might be worthwhile to note, for purposes of determining whether there is a business purpose for [redacted], whether there is a contract with [redacted] that requires reinsurance with [redacted], and if there is a contract with [redacted] that requires reinsurance with [redacted].

A sham argument may preclude taxation at two levels for 1987 and subsequent years. The two levels of tax exist if we tax [redacted] under I.R.C. §842 and we tax Taxpayer on dividends received from [redacted] (pursuant to I.R.C. §§956 and 951 or alternatively §316).

II. EXTENDED WARRANTY CONTRACTS/PROPERTY CASUALTY BUSINESS

A. Facts

The facts surrounding the extended warranty contracts sold by this Taxpayer are sketchy at best. We understand that the dealerships sold extended warranty contracts to car purchasers as prepaid service contracts. The dealer then made payments to either [redacted] (a contract administrator) or [redacted]. The dealerships retained commissions only - and acted as a receiving agent with respect to amounts remitted to [redacted] or [redacted]. In the case of [redacted], [redacted] allegedly made a payment to its sister corporation, [redacted] to acquire insurance coverage, but administered the contracts itself, paying claims, etc. In the case of [redacted], [redacted] apparently did not insure the warranty contracts with anyone but administered the contracts, paying claims as did [redacted]. We understand that Taxpayer's agreement with [redacted] enabled Taxpayer to personally withdraw the "reserves" kept by [redacted] in return for a written agreement that Taxpayer's dealerships would provide the required repair work without charge. These transactions do not even rise to a colorable argument for insurance treatment.

[redacted]'s only involvement in the warranty business was as the recipient of "kickbacks" from the administrators of approximately $[redacted] per contract. The dealerships sold the contracts for market price, forwarded an amount to the administrators who treated $[redacted] of the amount forwarded as an overpayment and forwarded the $[redacted] to whomever Taxpayer designated, frequently [redacted] via its bank account [redacted] (to which Taxpayer had personal access). [redacted] reported these amounts as "miscellaneous income" on its 1120F federal income tax return, not as property casualty insurance premiums. The consequence of which was however, to shelter such income from taxation by taking excess reserve deductions for the life reinsurance business. We are not sure how the other parties to the transaction, including the dealerships, accounted for these transactions.

You have indicated a belief that it is the egregiousness of this extended warranty scheme that prompts you to believe the Court will see [redacted] as a sham corporation. It seems plausible that a sham approach to the warranty "miscellaneous" income is appropriate and that those amounts should be attributed to Taxpayer. Note that this approach is to sham the transaction as opposed to a sham of the corporation ([redacted]).

B. General Warranty Cases

The more common form of extended warranty contract transactions is that a car dealer sells to a car purchaser a warranty contract. The contract may be directly with an independent property casualty insurance company, or the dealer may insure its liability with an independent insurer.[6] The dealer usually retains a commission amount and forwards the remaining premium to the unrelated insurer. The unrelated insurer however, usually reinsures with a wholly owned foreign subsidiary of the dealer, such as [redacted]

C. Section 842 - Alternative to Sham

Section 842 applies to property casualty insurers (we assume for purposes of this argument, that the offshore companies qualify as insurance companies under section 1.803-3(b)(1)) and taxes them on their income effectively connected with their U.S. trade or business. It is thus necessary to determine whether the is engaged in an U.S. trade or business, and whether the income is effectively connected to that business. See discussion, above on these issues.

As to whether the income is effectively connected to that business (assuming we determine that the kickbacks to [redacted] are income to [redacted] under the general definition in I.R.C. §61), there should be little doubt that the income is U.S. source. Regardless of the character of the income, it was paid by a car purchaser (presumably a U.S. citizen or resident) for a service to be performed by a dealer within the United States.

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[6]The National Office currently has several requests for Technical Advice pending regarding these extended warranty contracts. There is also a proposed revenue ruling being circulated which holds that where (1) an individual car owner purchases extended warranty coverage directly from a bona fide insurer and the contract does not require the contract holder to have repair work done at a dealership or garage in which the insurer has an ownership interest, that contract qualifies as insurance for purposes of subchapter L; and (2) an individual purchases a "repair service contract" from a car dealer who then insures his risk with a bona fide, unrelated insurer, the contract between the dealer and the insurer qualifies as insurance.

It would also seem logical to treat the income under I.R.C. §864(c)(2) as having been derived from the activities (sales) conducted by [redacted]'s agents located in the United States, i.e., the dealerships [redacted] and/or [redacted].

OTHER ALTERNATIVES

You may want to consider application of the various provisions of the I.R.C. discussed above as alternatives to the sham argument depending on your determination of the character of the kickbacks in the hands of [redacted] and whether those amounts increase [redacted] earnings and profits.

Please do not hesitate to call me at FTS 377-9493 or fax at FTS 566-3368 if you have any questions.

KAP

KIM A. PALMERINO

cc: Bill Bonano
Beth Williams